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WRONGFUL REFUSAL TO SETTLE BY A LIABILITY INSURER: THE STANDARD FOR ILLINOIS

Modern casualty insurance policies not only provide for indemnity payments to the insured, but also obligate the company to defend the insured in court[1] and, further, make it a violation of the policy conditions, which could give the insurer the right to deny coverage, if the insured injects himself into negotiations with the claimant.[2] The insured has in effect bartered away his rights to determine the facts and can no longer protect himself from the possibility of a large award of damages against him. It is also true that the insuring party can be held liable to the insured for a judgment in excess of the limits of the policy of insurance.[3]

When the possibility of a judgment in excess of policy limits exists, the insurer has a duty to consider the interests of the insured in negotiations for an out of court settlement.[4] While the insurance policy does not necessarily obligate an insurer to compromise a claim, it leaves the negotiations and the conduct of the defense up to the insurer, who must deal fairly in all respects with the insured.[5] The purpose of this note is to analyze "wrongful refusal to settle" in Illinois and to suggest that a higher standard of care should be imposed on an insurer in making the decision to refuse an out of court settlement which is within the limits of the stipulated insurance.

The law in other jurisdictions dealing with the appropriate standard of care varies. Some states apply the bad faith standard,[6] while others use the

[1] For example, the following is an excerpt from the standard auto insurance policy of the National Ben Franklin of Illinois Insurance Company:

> [T]he company shall defend any suit alleging such bodily injury or property damage and seeking damages which are payable under the terms of this policy, even if any of the allegations of the suit are groundless, false or fraudulent; but the company may make such investigation and settlement of any claim or suit as it deems expedient.

[2] A typical example of such a clause is the following which is taken from the standard auto insurance policy of the National Ben Franklin of Illinois Insurance Company:

> The insured shall not, except at his own cost, voluntarily make any payment, assume any obligation or incur any expense other than for such immediate medical and surgical relief to others as shall be imperative at the time of accident.

[3] Cernocky v. Indemnity Ins. Co. of North America, 60 Ill. App. 2d 196, 216 N.E.2d 198 (1966); Cowden v. Aetna Casualty & Surety Co., 389 Pa. 459, 134 A.2d 233 (1957); Ballard v. Citizens Casualty Co., 196 F.2d 96 (7th Cir. 1952); Communale v. Traders General Ins. Co., 50 Cal. 2d 654, 328 P.2d 198 (1958); Southern Farm Bureau Cas. Ins. Co. v. Mitchell, 312 F.2d 485 (8th Cir. 1963). See Keeton, *Liability Ins. & Responsibility for Settlement*, 67 Harv. L. Rev. 1136 (1954).

[4] Olympia Fields Country Club v. Bankers Indemnity Ins. Co., 325 Ill. App. 649, 60 N.E.2d 895 (1945).

[5] Wolfberg v. Prudence Mutual Casualty Co. of Chicago, 98 Ill. App. 2d. 190, 240 N.E.2d 176 (1968).

[6] Communale v. Traders General Ins. Co., 50 Cal. 2d 654, 328 P.2d 198 (1958); Hilleker v. Western Automobile Ins. Co., 204 Wis. 1, 231 N.W. 257 (1930), rehearing held to clarify the duty of the insured in negotiating a settlement, 204 Wis. 12, 235 N.W. 413 (1931); Hart v. Republic Mutual Ins. Co., 152 Ohio St. 185, 87 N.E.2d 347 (1949);

negligence standard.[7] The bad faith standard has grown out of the theory that the action brought by the insurer is for breach of the contract of insurance.[8] While there is no express provision in the contract of insurance stating that the parties will act toward each other in good faith, such a promise may be implied.[9] This duty is implied as a correlative of certain rights and privileges that the contract of insurance confers upon the insurer, i.e., the exclusive right to control the defense of the insured.[10] This promise appears to be what Williston would call a "'promise implied in fact."[11]

The negligence standard of care has grown out of the theory that the cause of action is one in tort.[12] The tort cause of action comes about because the insurer has a duty to the insured arising from the contract of insurance to use ordinary care in protecting the insured, and a breach thereof causing damages gives rise to an action ex delicto.[13] The Restatement calls this "The Negligent Performance of an Undertaking to Render Services."

> One who undertakes gratuitously or for consideration to render services to another which he should recognize as necessary for the protection of the others person or things is subject to liability to the other for physical harm resulting from the failure to exercise reasonable care to perform his undertaking.
>
> a. if his failure to exercise such care increases the risk of such harm.[14]

The Restatement further defines undertaking:

> In the ordinary case, the undertaking of one who renders services in the practice of a profession or trade is a matter of contract between the parties and the terms of the undertaking are either stated expressly or implied as a matter of understanding.[15]

Wakefield v. Globe Indemnity Co., 246 Mich. 645, 225 N.W. 643 (1929); Cowden v. Aetna Casualty & Surety Co., 389 Pa. 459, 134 A.2d 223 (1957). (Among the states that use the bad faith rule there are differences as to what amounts to bad faith).

[7] Stowers Furniture Co. v. American Indemnity Co., 15 S.W.2d 544 (Tex. Comm. App. 1929); Dumas v. Hartford Accident & Indemnity Co., 94 N.H. 484, 56 A.2d 57 (1947). *See* Alabama Farm Bureau Mutual Casualty Ins. Co. v. Dalrymple, 270 Ala 119, 116 So. 2d 924 (1959); Cuygasten v. General Accident, Fire and Life Ins. Corp., 283 F.2d 82 (7th Cir. 1960).

[8] *See* Hilleker v. Western Automobile Ins. Co., 204 Wis. 1, 231 N.W. 257 (1930), rehearing held to clarify the duty of the insured in negotiating a settlement, 204 Wis. 12, 235 N.W. 413 (1931); Georgia Co. v. Mann, 242 Ky. 447, 46 S.W.2d 777 (1932); Farmers General Co. v. St. Paul Mercury Indemnity Co., 186 Miss. 747, 191 So. 415 (1939); Johnson v. Hardware Mutual Casualty Co., 108 Vt. 269, 187 A. 788 (1936).

[9] Harris v. Standard Accident & Ins. Co., 191 F. Supp. 538 (S.D.N.Y. 1961); Best Building Co. v. Employers Liability Ins. Corp., 247 N.Y. 451, 160 N.E. 911 (1928).

[10] Hilleker v. Western Automobile Ins. Co., 204 Wis. 1, 231 N.W. 257 (1930), rehearing held to clarify the duty of the insured in negotiating a settlement, 204 Wis. 12, 235 N.W. 413 (1931).

[11] 6 Williston on Contracts, § 887 (3d ed. Jaeger 1962).

[12] *See* Dumas v. Hartford Accident & Indemnity Co., 94 N.H. 484, 56 A.2d 57 (1947); Stowers Furniture Co. v. American Indemnity Co., 15 S.W.2d 544 (Tex. Comm. App. 1929).

[13] Carne v. Maryland Casualty Co., 208 Tenn. 406, 346 S.W.2d 261 (1961).

[14] Restatement (Second) of Torts § 323 (1965).

[15] *Id.*

The insured has parted with his right to defend himself in regard to his liability to a claimant by the terms of the insurance contract, and he relies on the insurer to protect his interest.[16] If the insurer is negligent in investigating, evaluating, or negotiating a claim, he exposes the insured to the possibility of great financial loss in an excess judgment at trial.

Olympia Fields Country Club v. Bankers Indemnity Ins. Co.[17] was the first case decided in Illinois involving an action by the insured party against the insurer for an excess judgment. This case held that an insurer could not be held liable for a judgment in excess of the limits of insurance "absent a showing of fraud, negligence, or bad faith."[18] The court cited several sources which held that the insurer's duty to the insured arose out of the contract, and then applied the bad faith standard. But the holding did not completely eliminate application of the tort theory. The holding in *Olympia* required good faith of an insurer in the decision to refuse settlement, but also required ordinary care in conducting the investigation leading to this decision. This left Illinois with a dual standard of care and caused some confusion as to whether the action was ex contractu or ex delicto. This confusion was reflected in two cases, *Yelm v. Country Mutual Ins. Co.*[19] and in *Powell v. Prudence Insurance Company of Chicago*,[20] both of which managed to settle the issue in chief without answering the question of whether the action was in contract or tort.

Wolfberg v. Prudence Mutual Casualty Company of Chicago[21] suggests that Illinois favors the contract theory and the "bad faith" rule. *Wolfberg* was decided after *Powell* but before *Yelms*. In *Wolfberg*, the insurer failed to negotiate the suit against the deceased insured's estate. The claimants had made an offer of settlement for $17,000. Upon trial, verdicts totaling $55,000 were rendered. Thereafter execution was issued and served upon the insured's administrator.

[16] American Mutual Liability Ins. Co. of Boston, Mass. v. Cooper, 61 F.2d 446 (5th Cir. 1932).

[17] 325 Ill. App. 649, 60 N.E.2d 896 (1945).

[18] *Id.* at 673, 60 N.E.2d at 906.

[19] 123 Ill. App. 2d 401, 259 N.E.2d 83 (1970). This was an action for damages based on an insurers alleged negligent failure to settle a claim. The action was commenced by the judgment creditor of the insured against the insurer, the insured being neither a party plaintiff, or defendant. The appellate court affirmed the circuit court's dismissal of the case on motion by the insurer for failure to state a cause of action. The court stated in their holding, "The nature of the duty which forms the basis of the insured's liability appears to be the most important aspect to be considered." Whether the duty arises from contract or tort is a question difficult to resolve and usually unnecessary to determine, in the solution of a particular problem.

[20] 88 Ill. App. 2d 343, 232 N.E.2d 155 (1964). This was a garnishment action by an unsatisfied judgment creditor against a liability insurer of a judgment debtor. The plaintiff sued the insurer for the amount in excess of the policy limit as assignee subrogee, or third party creditor, beneficiary on the implied covenant of good faith in an insurance contract between insured and insurer. The defendant's theory was that if there was a claim, it was one in tort, hence not assignable in Illinois. The court held for the defendant saying that even if the implied contract theory correctly stated the law, this type of liability could not be reached by the Illinois Garnishment Act, 3 Ill. Rev. Stat. ch. 62 § 33 et seq. (1965).

[21] 98 Ill. App. 2d 190, 240 N.E.2d 176 (1968).

It was returned "no funds." Although the estate had not paid the judgment, a suit for excess judgment was brought against the insurer. The appellee insurance company defended on the theory that damage is an essential element of a negligence action, and since pecuniary damage was the essence of this negligence action and no pecuniary damage could be shown, the appellant's suit must fail. The appellate court reversed the trial court which dismissed the complaint for failure to allege the essential element of damage.[22] The appellate court cited authorities approving the bad faith rule and further stated that the action was one arising out of a "contractual relationship."[23] This case states that the action was one of contract, but what the court means by "contractual relationship" is not clear. The tort duty also arises out of the contractual relationship. Under the dual standard established in *Olympia*, it would seem that when the excess judgment resulted from bad faith negotiations, the insured's action should be on the contract. But, if the judgment resulted from negotiations based on a negligent investigation of the facts surrounding the injury, the insured's action should be in tort.

The cases following *Olympia* suggest that the breach is most likely to occur during the actual negotiations.[24] This may be an indication that the bad faith rule is not the appropriate standard because it is not really a breach of the contract but a failure of the insurer to adequately represent the insured at the settlement negotiations. It is further submitted that the negligence standard is the appropriate standard and that a "wrongful refusal to settle" should be considered a tort. The tort theory implementing the negligence standard of care, imposes a higher duty of an insurer.[25] The bad faith standard in Illinois states that an insurer must give as much consideration to the interests of the insured as it does to its own interests, and any failure to do so is bad faith.[26] The bad faith standard would seem to excuse poor judgment by an insurer in refusing to settle, as long as the decision is made in good faith. The courts should not tolerate poor judgment from insurance companies since their function in society is continually increasing as more and more citizens become dependent on their representation. The highest possible standard of care should be required of an insurer when deciding to place the financial future of the insured in the hands of a jury. The bad faith standard is subjective in that it requires the insured to prove the state of mind of the employees of the insurer.[27] This can be a difficult burden of proof

[22] *Id.*

[23] *Id.* at 198, 240 N.E.2d at 180.

[24] *See*, Yelm v. Country Mutual Ins. Co., 123 Ill. App. 2d 401, 259 N.E.2d 83 (1970); Powell v. Prudence Ins. Co. of Chicago, 88 Ill. App. 2d 343, 232 N.E.2d 155 (1966); Cernocky v. Indemnity Ins. Co. of North America, 60 Ill. App. 2d 196, 216 N.E.2d 198 (1966).

[25] Keeton, *Liability Insurance and Responsibility for Settlement*, 67 Harv. L. Rev. 1136, 1140 (1954). The author suggests that with skillful advocacy for the insured, the bad faith rule is practically equivalent to the negligence rule.

[26] Ballard v. Citizens Casualty Co. of New York, 196 F.2d 96 (7th Cir. 1952).

[27] Olympia Fields Country Club v. Bankers Indemnity Ins. Co., 325 Ill. App. 649, 60 N.E.2d 896 (1945).

to bear, and is another reason why a cause of action in tort is much more acceptable.

The tort theory gives more protection to the insurance buying public. The Restatement of Torts set forth the duty of one who undertakes to render services as follows:

> Unless he represents that he has greater or less skill, one who undertakes to render services in the practice of a profession or trade is required to exercise the skill and knowledge normally possessed by members of that profession or trade in good standing in similar communities.[28]

This standard of care requires an insurer, who competes for business by advertising his product through mass media to exercise acceptable skill in representing the insured. This tort standard is, by definition, objective. The decision of the insurance company to refuse an offer of settlement would have to be the same decision as would be made by other insurers in good standing in the community. In addition, expert witnesses would be available to testify on matters dealing with claims adjusting and supervisory decisions so that the insured can demonstrate the wrongful conduct of his representatives.

Appleman, in *Insurance Law and Practice*, sets forth a statement of his opinion of the insured's duty to defend:

> It has more than the duty of care of an ordinary man unskilled in litigation; it must exercise more than mere good faith. It is a professional which advertises by all media of mass communication its skill in the investigation, settlement, and litigation of liability. It asks the individual who is an amateur in these matters, but who would be deeply concerned over a case in which he is personally interested, to substitute its skill for its judgement for his judgement and its conduct for his own acts. It then becomes chargeable with a greater duty even as a brain surgeon must exercise greater knowledge, judgement, and skill in a brain operation than would a general practitioner of medicine.[29]

While Appleman is referring to the defense of the insured at the litigation stage, the pre-trial negotiation stage is also important to the defense of the insured, and the courts should require equally skillful handling at that stage.

There are other reasons which demonstrate that the action should be brought in tort. It is common knowledge that because of the backlog in most court systems, settlement of cases that can be resolved without a trial is desired. A higher standard of care under a negligence theory, if imposed on an insurer, could lead to a more careful evaluation of a case before taking it to trial, and thus force a settlement. Applying the shorter statute of limitations of two years for a tort action[30] in Illinois would encourage the insured to bring his action while insur-

[28] Restatement (Second) of Torts § 299A (1965).
[29] 7A Appleman Ins. L. & P. § 4687 (1962).
[30] Ill. Rev. Stat. ch. 83 § 16 (1969).

ance personnel, witnesses, and attorneys were still available, instead of allowing the ten year limitation for an action on the contract.[81]

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[81] Ill. Rev. Stat. ch. 83 § 17 (1969).